

A CONTRACTOR'S GUIDE TO
TERMINATION SETTLEMENT PROPOSALS

PRESENTED BY:



May 12, 2020

Relevant federal guidance

- ▶ March 20, 2020, Office of Management and Budget, MEMORANDUM TO THE HEADS OF EXECUTIVE DEPARTMENT AND AGENCIES, SUBJECT: Managing Federal Contract Performance Issues Associated with the Novel Coronavirus (COVID-19)
 - ▶ If contractors can't perform their contract due to COVID-19, it may be appropriate to procure elsewhere.
 - ▶ “Such actions should be taken for the convenience of the government [(e.g.,) through use of the relevant convenience termination or a no-cost settlement] and without negatively impacting the contractor's performance rating.
 - ▶ Memorandum notes that DoD contracts contain a number of different “termination clauses.”

Relevant federal guidance

- ▶ March 30, 2020, Office of Under Secretary of Defense Memorandum, SUBJECT: Managing Defense Contracts Impacts of the Novel Coronavirus
 - ▶ Clauses provide that “a contractor will not be in default because of a failure to perform the contract if the failure arises beyond the control and without the fault or negligence of the contractor.”

What Is a Termination for Convenience?

- ▶ It is a unilateral right, in favor of the Government, to terminate a prime contract for its convenience.
- ▶ A termination for convenience (T4C) allows the Government to cut short the life of the contract to avoid spending money on future performance.
- ▶ Terminations for convenience can be initiated for generally any reason other than cause (i.e., contractor default).
- ▶ Regulatory authority granting the right by the Government to terminate for convenience includes:
 - FAR Part 49 Termination of Contracts, 48 CFR Part 49
 - FAR 52.249 (termination contract clauses, 48 CFR Subpart 52.249)
 - Supplemental regulatory requirements
 - DFARS Part 249, 252.249 (clauses)
 - Other agency supplements
 - FAR 52.212-4(l)

What Is a Termination for Convenience?

- ▶ A TSP is a nonroutine request for payment (see *James M. Ellett Constr. Co. Inc. v. United States*, 93 F.3d 1537, 1542 (Fed. Cir. 1996)), which, if drafted in accordance with the requirements of the FAR, constitutes a claim under the FAR. *Id.* at 1543; see also FAR 49.001: “Claim, as used in this part, means the same as the language in 33.201.”

Notice of Termination

- ▶ The Contracting Officer shall terminate contracts for convenience by providing a written notification to the contractor, either electronically or through certified mail.
 - Required under FAR 49.102
- ▶ The termination notice will state the following:
 - That the contract is being terminated for the convenience of the Government (or for default) under the contract clause authorizing the termination;
 - The effective date of termination;
 - The extent of termination;
 - Any special instructions; and
 - The steps the contractor should take to minimize the impact on personnel if the termination, together with all other outstanding terminations, will result in a significant reduction in the contractor's work force.

Limits on the Government's Ability to Terminate a Contract for Convenience

- ▶ Government has broad discretion in electing to terminate a contract for the convenience of the government
- ▶ Boards and the COFC will overturn a termination for a convenience in two circumstances
 - ▶ Abuse of discretion
 - ▶ Bad faith
- ▶ Allegations of abuse of discretion are evaluated based on the existence of the following:
 - ▶ (1) evidence of subjective bad faith on the part of the government official;
 - ▶ (2) whether there is a reasonable, contract-related basis for the official's decision;
 - ▶ (3) the amount of discretion given to the official; and
 - ▶ (4) whether the official violated an applicable statute or regulation.
- ▶ Proving bad faith requires clear and convincing evidence, often termed “well-nigh irrefragable” proof.

You've Received a Termination Notice – Now What?

- ▶ Per FAR 49.104, the duties of a prime contractor upon receiving notice of termination include:
 - Stop work immediately on the terminated portion of the contract and stop placing subcontracts thereunder
 - Terminate all subcontracts related to the terminated portion of the prime contract – adhere to notification requirements (e.g., email, certified mail, etc.)
 - Immediately advise the TCO of any special circumstances precluding the stoppage of work
 - Perform the continued portion of the contract and submit promptly any request for an equitable adjustment of price for the continued portion, supported by evidence of any increase in the cost, if the termination is partial
 - Take necessary or directed action to protect and preserve property in the contractor's possession in which the Government has or may acquire an interest and, as directed by the TCO, deliver the property to the Government
 - Promptly notify the TCO in writing of any legal proceedings growing out of any subcontract or other commitment related to the terminated portion of the contract
 - Settle outstanding liabilities and proposals arising out of termination of subcontracts, obtaining any approvals or ratifications required by the TCO
 - Promptly submit the contractor's own settlement proposal, supported by appropriate schedules
 - Dispose of termination inventory, as directed or authorized by the TCO

You've Received a Termination Notice – Now What?

- ▶ In addition to the required steps, contractors should also develop a plan for conducting due diligence
 - Assign primary responsibilities to key stakeholders
 - Initial assessment, valuation
 - Perform preliminary contract review to quantify amount invoiced and paid to date

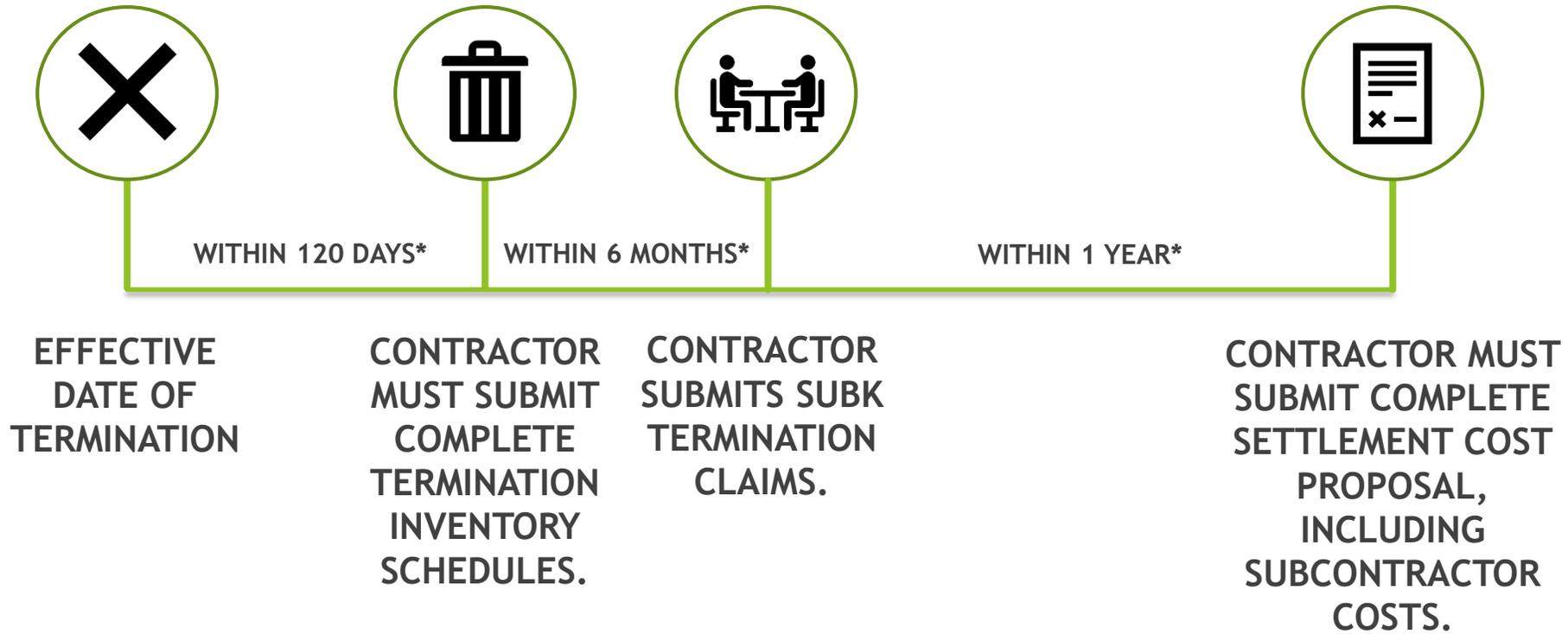
Know the Key Stakeholders

- ▶ Agency contracting personnel
 - Contracting Officer's Technical Representative (COTR)
 - Termination Contracting Officer (TCO)
 - Administrative Contracting Officer (ACO)
- ▶ Agency supporting personnel
 - Defense Contract Management Agency (DCMA)
 - Defense Contract Audit Agency (DCAA)
- ▶ Contractor personnel
 - Program manager and program support staff
 - Accounting & Finance team
 - Technical consultants and legal team
- ▶ It is important to keep in mind that the termination settlement proposal is meant to be reviewed by several parties, including:
 - The Procuring Contracting Officer (PCO)
 - The Termination Contracting Officer (TCO)
 - DCAA or customer's auditing arm
 - The Plant Clearance Officer

Types of T4C Settlement Proposals

- ▶ On claims over \$2,500, a contractor must decide whether to submit the termination settlement proposal on an **inventory** or **total cost** basis.
- ▶ Inventory basis (Government-preferred method)
 - Inventory is the basis for applying markups and arriving at a total claim.
 - Typically used in construction-type contracts, manufacturing-type contracts, and service contracts with unit pricing
- ▶ Total cost basis (requires prior approval from the contracting officer)
 - Advisable in circumstances where:
 - The nature of the accounting system or the nature of the contract does not lend itself to precise inventory pricing by part;
 - One is performing under a letter contract;
 - Substantial engineering and development work has been performed; and
 - A substantial portion of the costs incurred relates to production planning, starting load, etc.
- ▶ Under both bases, inventory schedules must be prepared.
- ▶ Under the inventory basis, the total inventory cost must tie out to the contractor's claim, whereas under the total cost basis the inventory is valued only for disposal purposes and its costs are intermingled under material, labor, and overhead categories.

T4C Timeline



** FROM EFFECTIVE DATE OF TERMINATION; IF ADDITIONAL TIME IS NEEDED, A CONTRACTOR MAY SEEK AN EXTENSION FROM THE TERMINATION CONTRACTING OFFICER (TCO).*

Contractor Recourse – Recover Your Costs

- ▶ To recover its costs, a contractor should prepare a termination settlement proposal that identifies all of the contractor's recoverable costs within a year of the termination of its contract.
- ▶ The following types of costs are generally allowable and recoverable under termination settlement proposal guidelines:
 - Initial costs (starting load and preparatory) not fully absorbed over the life of the contract due to the termination (e.g., idle time, training and learning curve adjustments, etc.)
 - Loss of useful value of special tooling, special machinery, and equipment
 - Rental costs under unexpired leases
 - Settlement expenses (see next slide)
 - Subcontractor claims
 - Indirect costs
- ▶ Claimed costs should be generally allowable, allocable, and reasonable.
- ▶ Contractors should consider seeking recovery of certain indirect costs by reclassifying them as direct costs, but would need to adjust its indirect pools to eliminate duplicative recovery.

Contractor Recourse – Recover Your Costs (Continued)

Contractor's goal should be to recover all costs. Consider:

- ▶ For performance to date of termination
 - Prime, subs, vendors, suppliers, consultants
- ▶ For implementation of termination
 - Costs as a consequence of termination
- ▶ Allowable, allocable, reasonable
- ▶ Direct costs – Fixed, variable
- ▶ Indirect costs
- ▶ Supply chain costs
- ▶ Profit – A reasonable measure, but not lost profits
- ▶ Assert claim for increased costs due to contract changes
- ▶ Minimize loss adjustment

Contractor Recourse – Claimed Costs

- ▶ Maximum amount of termination settlement may not exceed the sum of:

TOTAL CONTRACT PRICE
- PAYMENTS PREVIOUSLY MADE
- CONTRACT PRICE OF UNTERMINATED WORK
+ REASONABLE SETTLEMENT COSTS

- ▶ Reasonable settlement costs may include:
 - Accounting, legal, clerical, and other expenses reasonably necessary for preparation of termination settlement proposals and supporting data;
 - The termination and settlement of subcontracts (excluding the amounts of such settlements); and
 - Storage, transportation, and other incurred costs reasonably necessary for the preservation, protection, or disposition of the termination inventory.

Contractor Recourse – Termination Inventory

- ▶ Residual materials should be inventoried upon termination, and then physically segregated in a secure area for valuation
- ▶ If any of the inventory can be diverted to other contracts, they should be removed from the termination claim
- ▶ A complete listing of all inventory involved should be made – be sure to identify government-furnished property and equipment
- ▶ Complete termination inventory schedules should be submitted within 120 days after the effective date of the termination, unless extended in writing by the CO
- ▶ SF 1428 Inventory Disposal Schedule
 - Terminated inventory must be dispositioned by TCO
 - Sold at scrap or salvage value
 - Released to contractor
 - Delivered to government
 - Destroyed, disassembled, repurposed

Contractor Recourse – Subcontractors

- ▶ The prime contractor should ALWAYS flow down T4C rights to its subcontractors, vendors, suppliers, and consultants – otherwise, the prime contractor will assume the burden of the risk of breach of contract.
- ▶ Subcontractor termination claims should be submitted to the TCO within 6 months, although this timeline may be extended formally by the TCO through written request.
- ▶ Subcontractor termination claims should be audited by the prime contractor to validate the following:
 - Allocability, reasonableness, and allowability of claimed direct and indirect costs
 - Existence and condition of inventory and WIP items
 - Compliance with contract requirements (inspect WIP for conformity)
 - Need for loss adjustment
- ▶ Should use the same FAR forms

Contractor Recourse – What About Profit?

- ▶ Profit is generally only granted on preparations made and work performed up to the effective date of the termination (i.e., cannot claim future/unearned profits).
- ▶ Not allowable:
 - Lost profit on terminated future performance
 - Application of profit on materials and services undelivered to primer contractor as of effective date of termination
 - Application of profit on administrative (settlement) costs and expenses
 - Application of profit on consequential damages from the termination
- ▶ Allowable:
 - Profit on work completed or in process but terminated
- ▶ TCO discretion to arrive at Fair Profit Allowance FAR 49.202(a)
 - Nine factors drive the profit analysis, including complexity of work, level of staffing, efficiency, quality, quantity, etc.
- ▶ Contractor cannot be made whole for losses sustained during performance unless:
 - Loss resulted from increased cost due to changes issued by government
 - Contractor cannot reverse its fortunes just because of a termination

Contractor Recourse – What About Losses?

- ▶ Not all contracts are profitable
- ▶ No profit is granted if the contractor would have suffered a loss on a contract
- ▶ If the contractor anticipates a loss, an adjustment is made to the settlement proposal costs to reflect the percentage of loss anticipated had the contract not been terminated (i.e., the “loss ratio”) – it’s complicated
- ▶ Where loss results from increased cost of performance due to contractor error:
 - The amount to be paid for settlement proposal must be adjusted proportionately to preserve the loss position
 - Contractor cannot be made whole for its own errors
- ▶ Where loss results from increased cost of performance due to agency-directed changes or constructive changes:
 - Contractor should pursue a contract adjustment to reduce or eliminate the loss
 - Recover increased costs and cost of delays (impacts)
 - Claims for changes and other government-caused cost increases must be expressly preserved to avoid waiver, release
- ▶ Seek outside accounting and legal assistance
 - First determine whether loss was caused by government changes or other cause, or by contractor error or inefficiency
 - Validate all calculations for legal and accounting sufficiency and consistency with FAR cost principles and GAAP, or CAS if applicable

Contractor Recourse – What About Losses? (Continued)

▶ Loss ratio =

(A) TOTAL CONTRACT PRICE

(B) TOTAL COST INCURRED UP TO EFFECTIVE DATE OF TERMINATION + ESTIMATE-TO-COMPLETE COSTS

- If (A) < (B) → Contract would have suffered a loss; termination settlement recovery will be reduced by the loss ratio
- If (A) > (B) → Contract would have been profitable; loss adjustment forgone

Contractor Recourse – Methods of Settlement

- ▶ Per FAR 49.103, settlement of terminated cost-reimbursement and fixed-price contracts terminated for convenience may be effected by:
 - Negotiated agreement;
 - Determination by the TCO;
 - Costing out under vouchers using SF 1034, Public Voucher for Purchases and Services Other Than Personal, for cost-reimbursement contracts; or
 - A combination of these methods.
- ▶ Per FAR 49.105-2, the TCO shall estimate the funds required to settle the termination, and within 30 days after the receipt of the termination notice, recommend the release of excess funds to the contracting officer.
 - Contractor should consider submitting a ROM of the value of its settlement proposal (without certifying it) within this 30-day period to preserve funding.
- ▶ Upon receipt of a contractor's T4C proposal, the Agency will proceed to:
 - Review the contractor's T4C proposal
 - Conduct financial and material audits
 - Confer with counsel and program personnel
- ▶ The objective is to negotiate a resolution – if no resolution is achieved, the matter may be resolved through dispute resolution.

Settlement by Determination

- ▶ The TCO has the authority to settle termination settlement proposals unilaterally via determination
- ▶ This authority is generally enacted if:
 - The TCO and the contractor are not able to reach an agreement
 - The proposal is submitted late
 - The contractor fails to provide adequate information
- ▶ Per FAR 49.109-7(f), the contractor may appeal any settlement by determination
- ▶ Contractor should be responsive to TCO's requests for information, documents
- ▶ Legal fees for appeals may not be recovered

Price Adjustment for Remaining Work

- ▶ Partial termination may adversely impact cost of performance for remaining (unterminated) work
- ▶ Price adjustment using form at FAR 15-2, under FAR 15.408
 - Form facilitates government audit
- ▶ Contractor must validate that amounts sought in price adjustment are not also included in settlement proposal
 - No double recovery

Applicable Standard Forms

- ▶ Forms for the settlement of terminated contracts include:
 - SF 1435, Settlement Proposal (Inventory Basis) → Used to submit settlement proposals resulting from the termination of fixed-price contracts if the proposals are computed on an inventory basis
 - SF 1436, Settlement Proposal (Total Cost Basis) → Used to submit settlement proposals resulting from the termination of fixed-price contracts if the proposals are computed on a total cost basis
 - SF 1437, Settlement Proposal for Cost-Reimbursement-Type Contracts → Used to submit settlement proposals resulting from the termination of cost-reimbursement contracts
 - SF 1438, Settlement Proposal (Short Form) → Used to submit settlement proposals resulting from the termination of fixed-price contracts if the total proposal is less than \$10,000
- ▶ Other applicable standard forms under the T4C process include:
 - SF 1428, Inventory Disposal Schedule
 - SF 1429, Inventory Disposal Schedule – Continuation Sheet
 - SF 1439, Schedule of Accounting Information (filed in support of a settlement proposal unless the proposal is filed on SF 1438)
 - SF 1440, Application for Partial Payment (used to apply for partial payments)

T4C Proposal Audits

- ▶ The TCO is responsible for ordering audits of settlement proposals (prime & sub).
- ▶ Any proposals submitted with claimed costs over the certified cost or pricing data threshold are required to be audited.
- ▶ Any proposal submitted with claimed costs under \$100,000 will be audited at the TCO's discretion.
- ▶ It is best practice to audit any subcontractor proposals submitted to the TCO, regardless of value.
 - This will avoid delay and potential unwanted scrutiny in the Government's review/audit.
 - The costs associated with the prime contractor's audits of its subcontractor proposals would be considered an allowable cost and would also be recoverable as part of the settlement proposal.

Audited Indirect Cost Rates, FAR 49.303-4

- ▶ Obtaining audited indirect cost rates for every period of performance up to effective date
 - Can take years to conduct and complete audits
 - Still longer to negotiate final rates
- ▶ TCO has discretion to negotiate with contractor to set indirect rates for the termination settlement
 - Provisional rates
 - Lump sum for indirect costs
 - Reserve for later settlement the indirect costs to allow completion of remaining settlement elements
- ▶ Lump sum allowances for indirect costs will require contractor to adjust affected cost pools to avoid double recovery

Common Contractor Pitfalls

- ▶ Failing to retain supporting documentation
- ▶ Failing to flow down pass-through rights that allow the prime to similarly terminate its subcontractors
- ▶ Lack of planning/foresight
- ▶ Weak cost controls
- ▶ Disorganized and/or scattered contract administration
- ▶ Inadequate proposal coverage (i.e., failing to document key assumptions, not providing notes regarding important cost considerations, etc.)
- ▶ Failing to act in a timely manner
 - Changes – constructive and directed
 - Provide notice of contract/budget overrun
 - Government-caused delay, impacts
 - Communicate
 - Troubleshoot
- ▶ Inadequate planning and price analysis of special tooling, fixtures, and equipment
 - Sunk costs may be at risk
- ▶ Not reviewing or auditing any subcontract termination proposals

Common Contractor Pitfalls (Continued)

- ▶ Flawed contractor assumptions
 - ▶ Understand your cost and pricing model
 - ▶ Disproportionate cost incurrence relative to unit pricing
- ▶ Base period – cost of performance
 - ▶ Items acquired in year 1 for use in later years
 - ▶ Costs incurred in year 1, to be recovered in later years
- ▶ What is your exposure, your business risk, for disproportionate cost incurrence relative to sales?

Other Considerations

- ▶ T4C risk management starts during the solicitation process
- ▶ Identify solicitation requirements, evaluation and selection criteria, terms and conditions that could give rise to unconventional cost/price modeling
- ▶ Quantify risk and quantify consequence to identify exposure
- ▶ In your proposal, consider including:
 - ▶ End notes calling out important cost considerations, such as:
 - ▶ If a contract is terminated for convenience in whole or in part before completion of option year two, contractor shall be entitled to recover as a termination cost, the full measure of fixed costs incurred before effective date of termination.
 - ▶ Key assumptions, such as:
 - ▶ We assume agency will purchase x units over y years
- ▶ Ask pertinent questions up front
 - ▶ Will proposal be incorporated into contract? If so, assumptions, end notes will/should become part of the contract terms and conditions – binding effect
 - ▶ Will proposal merely be a reference document? If so, proposal is informational, not necessarily binding
 - ▶ Will selected parts but not all of proposal be incorporated, such as pricing schedule? Arguably the whole proposal should be binding because pricing is per se tied to the performance described elsewhere – debatable question

Other Considerations (Continued)

- ▶ Prime contractor SHOULD flow down T4C rights to:
 - Subcontractors, vendors, suppliers, consultants
 - Without flowdown, prime contractor assumes breach of contract risk for subcontractors
 - UCC damages that are broader than FAR, DFARS
- ▶ SF 1435 includes extensive certification
 - Must be signed by contractor
- ▶ False Claims Act liability for knowingly submitting false statements, false claims, false certifications
- ▶ Due diligence plan is focused on mitigating risk of FCA liability stemming from the settlement proposal

Can I Get a Mulligan on the TSP?

- ▶ Failure to observe timing and procedural requirements
 - ▶ *American Boys Construction Co.*, ASBCA No. 61163, 18-1 BCA ¶ 36949.
- ▶ Inadequate recordkeeping and documentary support
 - ▶ *American Geometrics Construction Co.*, ASBCA 37734, 92-1 BCA ¶ 24545.
- ▶ Failure to minimize costs incurred
 - ▶ *Advanced Global Resources, LLC*, ASBCA No. 62070, 19-1 BCA 34733.

What Can You Do to Prepare?

- ▶ **PLAN AHEAD!**
- ▶ Review and understand solicitation provisions – understand how these may influence a T4C
 - FAR 52.249-x
 - DFARS 252.249-x
 - DFARS Procedures, Guidance and Information (PGI) Part 249
- ▶ Document, document, document
 - Make sure you retain all of your subcontractor, consultant, supplier, and vendor invoices and receipts, as well as original proposal/bid documents.
- ▶ Don't be afraid to ask for help!
 - Hiring experts to help with termination settlement negotiations and proposal development will help contractors maximize their recovery while minimizing their administrative burden.
 - Costs for any outside experts/consultants in preparing and negotiating the termination settlement proposal are allowable and recoverable as settlement costs within the termination settlement proposal.

Questions?

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Upcoming Webinar Presentations

- ▶ **Tuesday, May 26, 2020: A Government Contractor's Guide to the Civil False Claims Act During the COVID-19 Pandemic**
 - ▶ Presenters:
 - ▶ Paul Debolt, Partner, Venable LLP
 - ▶ Randy Seybold, Partner, Venable LLP
 - ▶ Caleb McCallum, Associate, Venable LLP
 - ▶ Erin O'Shea, Director- Industry Specialty Services - Government Contracts, BDO USA, LLP

- ▶ **Tuesday, June 2, 2020: CARES Act: It Ain't Money for Nothing - A Government Contractor's Guide to Mandatory Disclosures**
 - ▶ Presenters:
 - ▶ Paul Debolt, Partner, Venable LLP
 - ▶ Spencer Williams, Associate, Venable LLP
 - ▶ Derek Shaw, Managing Director, Industry Specialty Services - Government Contracts, BDO USA, LLP